

**Testimony of
The Honorable Otto Wolff
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Before the
Subcommittee on Government Management, Finance and Accountability
Committee on Government Reform
United States House of Representatives**

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The Effectiveness of Internal Control

Thank you, Mr. Chairman and members of the Subcommittee.

I am pleased to appear before you today to discuss how my colleagues in the federal financial management and audit communities have come together in concert with the Office of Management and Budget (OMB) to strengthen the internal control requirements over financial reporting within the Federal Government. As a result of this effort, we have substantially improved the accountability and oversight of internal controls of federal departments and agencies.

These changes were the result of the Administration taking a proactive and collaborative approach to improving financial management in the federal government. They are embodied in the revised OMB Circular A-123: *Management's Responsibility for Internal Control* (A-123), which was signed in December by OMB Director Bolten. The revised Circular A-123 will help federal managers ensure proper controls are in place, documented, and tested. These changes will also strengthen the existing internal control assessment process, in a cost-effective manner. Additionally, these improvements will further support the goals of the President's Management Agenda by promoting a foundation of good controls from which timely and reliable financial information can be developed.

Collaborative and Coordinated Approach

As we are all too aware, highly publicized corporate failures and accounting scandals in recent years revealed a lack of accountability and proper controls over financial reporting publicly-held companies, prompting the passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act). This legislation included the first ever requirement that publicly-held firms undertake significant efforts to provide assurance on the effectiveness of their financial reporting process, as well as obtain an audit opinion on internal control in addition to the traditional financial statement audit. With the passage of the Sarbanes-Oxley Act and the Department of Homeland Security Financial Accountability Act of 2004, the Executive Branch took the opportunity to re-examine the internal control requirements within the Federal Government.

In November 2003, former OMB Controller Linda Springer initiated a joint committee of the Chief Financial Officers' Council (CFOC) and the President's Committee on Integrity and Efficiency (PCIE). This joint committee was tasked with surveying federal agencies to identify differences in how current requirements are being implemented, reviewing the requirements of publicly-traded companies as laid out in the Sarbanes-Oxley Act, and reporting how those requirements may, or may not, apply to the Federal Government.

The joint committee first examined the fundamental differences between the public and private sectors. Federal entities operate in an environment steeped in regulations, policies, and procedures intended to ensure that all fiscal and budgetary actions are legal. Because the goals and motivation of federal entities differ fundamentally from the private sector, they are much less vulnerable to the risk of manipulating financial reporting to achieve personal gain. Also, the actions of federal entities are open to public scrutiny and subject to multiple levels of oversight, including Congress, OMB, the Government Accountability Office, (GAO), and independent Inspectors General (IG).

Unlike the private sector, the actions of federal entities are subject to a myriad of laws and regulations designed to promote prudence and accountability. Examples of legislative requirements that support effective internal control include:

- the Federal Managers' Financial Integrity Act (FMFIA);
- the Federal Information Security Management Act (FISMA);
- the Inspector General Act;
- the Chief Financial Officers Act;
- the Government Management Reform Act;
- the Federal Financial Management Improvement Act; and
- the Improper Payments Information Act.

At the center of these requirements is the FMFIA which establishes overall internal control requirements. This Act encompasses controls in programs, operational and administrative areas, as well as accounting and financial management. It also requires the agency head to evaluate and report on the controls and financial systems that protect the integrity of federal programs.

Other regulatory requirements also exist to support effective internal control. For example, OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, requires auditors of federal financial statements to test and report on agencies' internal controls over financial reporting in connection with the audit of the financial statements. Auditors must report internal control material weaknesses and reportable conditions as part of the annual financial audit process. These auditor-identified material weaknesses are reported annually to the President and Congress in each agency's Performance and Accountability Report (PAR).

After the joint CFOC/PCIE committee reviewed the existing federal internal control requirements in OMB Circular A-123. It then recommended that OMB strengthen this guidance for assessing the effectiveness of internal control. The committee developed amendments to Circular A-123 that would adopt the standards of internal control commonly

used by the private sector and developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and published in its *Internal Control – Integrated Framework* document. These standards were adopted previously by the GAO in its *Standards for Internal Control in the Federal Government* (commonly known as the GAO Green Book). Key points and definitions from the GAO/PCIE Financial Audit Manual were also included in the amendments. As you see, we did not reinvent the wheel in amending A-123, we adopted private-sector standards that were tailored to be more specific and more responsive to the government environment.

Revised OMB Circular A-123

The most significant change to Circular A-123 is the requirement for agency management to follow a more comprehensive and coordinated approach when assessing the effectiveness of internal control over financial reporting and to document its assessment. Management must identify, test and document internal control effectiveness over financial reporting. Circular A-123 defines the scope of financial reporting to include financial statements, significant other financial reports and compliance with the laws and regulations that pertain to financial reporting. The outcome of the assessment process is a new separate assurance statement from management to be included in agency PARs on the effectiveness of the internal control over financial reporting.

Circular A-123 also includes a provision to permit OMB to require a separate audit of internal control under certain circumstances. Thus, if an agency fails to meet its deadlines outlined in its corrective action plan to resolve material weaknesses, OMB may direct a separate audit of internal control to better focus management's internal control improvement plans. This approach is a cost-effective way to implement a separate audit requirement.

The amendments to Circular A-123 are effective beginning in FY 2006. This fiscal year, federal agencies will be taking steps to prepare for its implementation. Here at Commerce, we have already begun to develop a plan that will identify the financial reporting scope, risk factors to assess, materiality levels, key controls, documentation requirements, and testing strategy. We will work in consultation with our Office of Inspector General to ensure effective implementation. The actual testing of controls is scheduled to begin in the second quarter of fiscal year 2006. We will then be in position to prepare our first management assurance statement for internal control over financial reporting as of June 30, 2006, to be included in our Performance and Accountability Report due November 2006.

In addition, the CFO Council plans to develop an implementation guide for A-123, which will complement the policy document and provide a more hands-on approach to the assessment process of internal controls over financial reporting. The CFO Council will also sponsor training to assist federal agencies in meeting the new requirements.

Related Initiatives

In addition to the separate assurance statement in agency PARs, internal control improvements are also being tracked through the quarterly scorecard process of the Improved

Financial Performance initiative of the President's Management Agenda (PMA). The Improved Financial Performance initiative emphasizes the need for effective internal control, and getting to a "green" score on the scorecard requires agencies to eliminate all material internal control weaknesses. Ultimately, the goal is to ensure managers are making more timely and informed decisions on operations and costs at both the program and agency-wide levels. Yet, this objective cannot be achieved without a foundation of effective internal control from which reliable financial information can be routinely generated and used to support management decisions.

I am pleased to report that Commerce recently attained "green" status in the Improved Financial Performance PMA initiative in the first quarter of fiscal year 2005. We are proud of our success, and that of the seven other CFO Act agencies that have also achieved that status. The efforts involved at a cabinet-level agency to overcome obstacles to obtain a clean audit opinion, integrate financial management systems, and eliminate material weaknesses cannot be overstated. With a higher bar now set out by Circular A-123, we realize that its implementation will require a serious and focused effort.

It should also be noted that the accelerated federal financial reporting requirement has also served as a significant motivating factor for improved internal controls. Agencies have had to strengthen their controls over financial reporting in order to meet the current accelerated due dates for financial statement preparation and audit from five months after the end of the fiscal year (as it was only a few years ago) to 45 **days** after the fiscal year (as it was for FY 2004). Because they are no longer able to rely on workarounds, or "compensating controls," agency CFO teams have invested additional resources in CFO operations and have reviewed their accounting systems and processes from a fresh perspective in preparing to meet the accelerated reporting requirement. New approaches to compiling accounting information, closing the books, and assembling financial statements and PARs have been implemented in order to meet the aggressive deadlines.

Cost Analysis

As part of the joint committee's review, agencies were polled to better understand the costs associated with conducting internal control assessments and audits. Unfortunately, the majority of agencies did not have sufficient experience with the process envisioned in Circular A-123 to be able to estimate the costs with any degree of certainty. Other agencies have been performing the internal controls work for so long that solid data on costs is likewise hard to separately identify. We will continue to work with agencies to identify more specific cost data. Likewise, additional cost data should soon be available from the private sector relating to implementing the Sarbanes-Oxley Act requirements.

Conclusion

In closing, I would like to acknowledge the excellent collaboration and support in addressing this issue on the part of the PCIE and OMB, working with the CFO community. In addition, we received helpful suggestions from your subcommittee staff and GAO in our discussions with them. The approach presented here should be a model for how we can work together to

ensure that federal programs operate as effectively and efficiently as possible. It is incumbent on us all to keep the federal financial community focused on this stewardship responsibility.

Mr. Chairman, thank you again for this opportunity to speak to you today. I would be happy to entertain any questions you or the members of the subcommittee may have.